United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

75-7049

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

ANITA B. BRODY,

Plaintiff-Appellant,

—against—

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK and THE FIDELITY BANK,

Defendants-Appellees,

—and—

PENNSYLVANIA COMPANY,

Defendant.

(ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK)

PLAINTIFF-APPELLANT'S REPLY BRIEF

WOLF POPPER ROSS WOLF & JONES
Attorneys for Plaintiff-Appellant
845 Third Avenue
New York, New York 10022
PL 9-4600

BENEDICT WOLF
LESTER L. LEVY
Of Counsel

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PLAINTIFF-APPELLANT'S REPLY BRIEF

PRELIMINARY STATEMENT

In this appeal from the final judgment of the United States District Court (Gagliardi, J.) dismissing the action with prejudice on the ground that plaintiff failed to satisfy the pleading requirements of Fed. R. of Civ. P. 23.1, we have stated the facts and issues on appeal in our main brief.

POINT I

UNDER THE CIRCUMSTANCES OF THIS CASE, NO DEMAND ON THE DIRECTORS WAS NECESSARY PRIOR TO THE INITIATION OF THE ACTION.

Defendants have failed to show that the allegations setting forth the futility of having to make demand on the Pennco directors prior to the initiation of suit do not meet the pleading requirements of Rule 23.1. In fact, defendants have chosen to attempt to rebut only four of the seven specific allegations contained in paragraph 26 of the second amended complaint (100a-104a).*

With respect to those allegations defendants do attempt to rebut, we briefly note that in an effort to overcome the effect of Pennco's efforts to dismiss the earlier action, Defendant Banks have implied that this opposition was because plaintiff allegedly lacked capacity to sue on behalf of Pennco. An examination of Pennco's motion (51a-54a) reveals that what Pennco's directors were

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* As we pointed out in our main brief at page 17, it is well-settled that the Court should consider the whole complaint and not merely the paragraph in which plaintiff summarizes her reasons for not demanding action by the corporation, to see if equity compels that demand be excused. In the light of the obvious impropriety of the loan transaction challenged in this suit, the directors' inaction and their hostility to plaintiff's efforts to set aside the loan are prima facie inexplicable.

attempting to do was to have the action dismissed and to this end raised a veritable barrage of objections, including lack of jurisdiction, improper venue, lack of capacity to sue, failure to join an indispensible party, adequate remedy at law and an argument that the Court should abstain from hearing this suit since it would be an interference in the affairs of a foreign corporation. Defendants, attempting to create a reason for the Board's actively seeking dismissal of the earlier action, speculate that it was because of the possible noncollectibility of a judgment against the defendants in the earlier action, although there is absolutely no basis in fact for the assumption of noncollectibility. What is clear is that the Pennco Board, by seeking to dismiss the earlier action, was actively opposing an attempt to ascertain the merits of the charge that the loan was a fraud on Pennco.

This is not an instance, as was Nussbacher v. Continental Illinois Bank & Trust Company of Chicago, 61 F.R.D. 399 (N.D. Ill. 1973), appeal pending, cited on page 21 of defendants' brief, where plaintiff's complaint alleged merely that she was not required to make a prior demand on the Board because, in connection with an earlier action, plaintiff "had initiated a discussion with representatives of Leasco (the derivative corporation) to

determine whether Leasco would assist her in the prosecution of that action" and the corporation refused to assist her. 61 F.R.D. 404.* Here, the directors were actively opposing plaintiff's attempt to challenge the loan transaction.

Defendant Banks also attempt to refute the allegations in the complaint which set forth the personal stake the Pennco directors had in retaining their directorships by seeking to minimize the remuneration that these individuals received and the possible threat to this continued remuneration if the Defendant Banks, among others, became large stockholders of Pennco.** However, it is clear that the remuneration in question was not the traditional gold coin or a $500 fee for attending a meeting, but was in excess of $25,000 a year

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* See, Schwartz v. Romnes, 357 F. Supp. 30 (S.D.N.Y. 1973) reversed on other grounds, 495 F.2d 844 (2d Cir. 1974), where demand was excused because demand in a related case had been made and the corporation refused to act upon it.

** The defendants confuse the purpose of an amended complaint with that of a supplemental complaint when they argue that plaintiff, at the time she filed her second amended complaint, knew that the reorganization court had declined to approve the transfer of the common stock to the banks. This subsequent event could not have been foreseen by the directors at the time of the institution of this suit. Furthermore, as the defendants state, this declination was only "for the present" and this does not weaken the plaintiff's argument.

just for serving on the Board (with respect to two of the four directors) and far greater income with respect to the two others, who were also employed as officers of Pennco. The fact that some of these directors may be astute businessmen or experts in their fields or even give good service for their pay, would not lessen their desire to retain these substantial fees.

Defendants next argue that plaintiff was not excused from having to make a demand on the Pennco directors for action as she does not charge these directors with having profited from the loan or with self-dealing. The law is clear, however, that allegations of directorial fraud or self-interest are not a prerequisite to excusing a derivative shareholder from making demand where the actions of the directors indicate a failure of their affirmative duties of due care and diligence to the corporation.

A case very much in point is the recent unanimous decision of the New York Court of Appeals in Barr v. Wackman, -N.Y.2d- (April 1, 1975).* In that case, plaintiff brought a shareholders' derivative action without making a demand, alleging that demand would have been futile. The Board of Directors of the derivative corporation consisted

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* The decision, not yet officially reported, was set forth in full in the New York Law Journal, April 22, 1975, pages 1, 5.

of 16 members. Five of the sixteen were alleged to be affiliated with the derivative corporation in official capacities in addition to their positions as directors and were alleged to have profited from the wrongdoing set forth in the complaint. The complaint did not allege that the other eleven directors were affiliated with the derivative corporation, except in their capacities as directors. No self-dealing was alleged with respect to the majority of the directors, but they were alleged to have failed to perform their duty to protect the corporation from the self-dealing of others. The issue on appeal was whether the complaint set forth sufficient reason to excuse plaintiff from having to make a demand on the directors prior to the initiation of the law suit.*

The Court of Appeals reiterated at the outset the well-established principle that on a motion to dismiss for failure to state a cause of action, every fact

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* New York Business Corporation Law, §626, ¶c, provides that in any shareholders' derivative action brought in the right of the corporation to procure judgment in its favor, the complaint shall set forth with particularity the efforts of the plaintiff to secure the initiation of such action by the Board or the reasons for not making such effort.

alleged must be assumed to be true and the complaint liberally construed in plaintiff's favor and after evaluating the purposes behind t.. derivative demand requirement, concluded ". . . it is clear that the demand is genera.. designed to weed out unnecessary or illegitimate shareholders' derivative suits. This prophylactic device assuredly should not be allowed to frustrate the true derivative suit, the very thing it was designed to protect". (N.Y.L.J., April 22, 1975, p. 5, col. 4) The court pointed out that transactions challenged by the plaintiff were entered into by the corporation not for its benefit, but for the benefit of others. The court, finding that the complaint, considered most favorably to the plaintiff, indicated that the majority of the directors had disregarded the corporation's interest, went on to say:

> "We reject appellant's proposition that allegations of directorial fraud or self-interest is, in every case, a prerequisite to excusing a derivative shareholder from making a demand upon the board. (Compare, e.g., In re Kaufmann Mutual Fund Actions, 479 F 2d 257, 265 1st Cir. 1973; cert. den. 414 U.S. 857; but see, concerning opinion of Chief Judge Coffin; see also 8 Suffolk U.L. Rev. 287). Directors undertake affirmative duties of due care and diligence to a corporation and its shareholders in addition to their obligation merely to avoid self-dealing." (Id. at col. 6)

The Court of Appeals said further that though the directors may not have personally profited from the challenged acts, that does not necessarily end the unlikelihood that they would prosecute the action.

> "No custom or practice can make a directorship a mere position of honor void of responsibility, or cause a name to become a substitute for care and attention. The personnel of a directorate may give confidence and attract custom; it must also afford protection." (Id. at col. 6)

And while the court stated that, of course, the degree of care and diligence to be exercised will depend upon the facts of each case,

> "the so-called 'business judgment' rule (citation omitted) urged by appellants had not drained the traditional duties of prudence and diligence of all their contemporary validity and force. (citations omitted)" (Id., col. 6)

The Court of Appeals rejected all of defendants' arguments and held that plaintiff could prosecute the derivative action, even though he had not made a demand on the Board to institute the action.

The facts in this case, as alleged in the second amended complaint, describe more sharply even that does Barr v. Wackman a situation of directorial inaction, of a failure to protect Pennco, and of apparent directorial indifference to the interests of the corporation. The Pennco Board of Directors in office at the time of suit had not only failed to take any affirmative action to challenge

the questionable loan transaction despite the fact that the Pennco Board had known of the transaction at least since the members started to serve (seven to nine months before this action was commenced), they were actually seeking to dismiss plaintiff's previous action seeking to challenge the loan. When fiduciaries do not use their power for the benefit of their cestui qui trust, whose interest alone they should protect, but rather protect through their action or inaction, the advantage and profit of a third person, such conduct is enough to charge them with a duty to account. Clayton v. Farish, 73 N.Y.S. 2d 727, 740, 746 (Sup. Ct., N.Y. Co. 1947). Clearly, such conduct by the Board excuses plaintiff's having to make a futile demand of them to bring action.*

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* Defendants are clearly incorrect in their view of the law that "failure to make demand can only be excused by an explicit and unequivocal factual showing of wrongdoing or bias" (defendants' brief, p. 18). While defendants cite no authority for that assertion, the authorities to the contrary are clear. As we pointed out in our main brief, the Supreme Court held in Del. & H. Co. v. Albany & S.R. Co., 213 U.S. 435 (1909) that, in excusing demand the good faith of the directors need not be questioned, their attitude may not be sinister, and, in fact, they may be sincere. Demand will be excused when the directors occupy antagonistic grounds to plaintiff in respect to her claims. See also, Cathedral Estates v. Taft Realty Corp., 228 F.2d 85 (2d Cir. 1955); Barr v. Wackman, supra. O'Connor v. Virginia Passenger & Power Co., 184 N.Y. 46 (1906), relied on by defendants, does not support defendants' statement of the law. In any event, the law of New York is now established by Barr v. Wackman, supra.

In sum, the allegations of the complaint, viewed liberally in plaintiff's favor, more than adequately meet the pleading requirements of Rule 23.1. As the Court of Appeals stated in Barr v. Wackman, supra, while the director demand request was designed to weed out unnecessary or illegitimate shareholder derivative actions, it should not be allowed to frustrate the true derivative suit; the very thing it was designed to protect. It certainly should not be allowed to frustrate the suit at the sole instance of the persons charged with the defrauding of the corporation.

POINT II

DEFENDANTS HAVE FAILED TO REFUTE PLAINTIFF'S ARGUMENT THAT JUDGE GAGLIARDI ERRED IN DETERMINING THAT RULE 23.1 REQUIRES PLAINTIFF TO DEMONSTRATE THE FUTILITY OF MAKING DEMAND TWO AND ONE-HALF YEARS AFTER THE ACTION WAS COMMENCED.

Plaintiff has pointed out in her main brief that the unique decision below requiring that plaintiff allege the futility of having to make demand at the time of an amendment to the complaint, two and one-half years after the action was commenced, is contrary to Rule 15(c) of the Federal Rules of Civil Procedure. Defendants' sole response to plaintiff's argument is their assertion that Rule 15(c) is applicable only in a statute of limitations context. Defendants cite no judicial support for that assertion, since neither Rule 15(c) nor the judicial authorities interpreting it support their assertion.

Courts have consistently applied "relation back" in numerous and varied circumstances dealing with amendment of complaints. For example:

In Miller v. Laird, 464 F.2d 533 (9th Cir.1972), the Court held that the filing of an amended petition related back to the date of the original petition, so as to keep jurisdiction in the district court notwithstanding the removal of the appellant from the district.

In Nedd v. Thomas, 47 F.R.D. 551 (M.D. Pa. 1969), the Court of Appeals had determined that jurisdiction did not lie on the grounds asserted in the original complaint, but had granted leave to file an amended complaint. After plaintiffs had filed their amended complaint, defendant moved for a protective order with respect to plaintiffs' interrogatories which were outstanding and had been outstanding when the case was on appeal on the jurisdictional issue. Defendant argued that since the Court of Appeals concluded that no jurisdiction originally existed in the case, the former proceedings were a nullity and consequently defendant should not be required to answer the interrogatories. The court rejected defendants' arguments stating at page 554:

> "[T]o hold that the prior proceedings were a 'nullity' would seriously conflict with Rule 15 of the Federal Rules, which states, in part: 'Whenever the claim or defense asserted in the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading, the conduct relates back to the date of the original pleading.'".

See also, Fifty Associates v. Prudential Ins. Co. of America, 446 F.2d 1187 (9th Cir. 1970) [jurisdiction originally defective, corrective amendments applied retroactively]; Metropolitan Liquor Co. v. Heublein, Inc., 50 F.R.D. 73 (E.D. Wis. 1970) [where the Court admonished defendants that the Supreme Court in Foman v. Davis, 371 U.S. 178

(1962) had held that Rule 15 should be liberally construed since it is not the policy of the federal courts to avoid decisions on the merits on the basis of technicalities]; Fujii v. Dulles, 224 F. 2d 906 (9th Cir. 1955); MacGowan v. Barber, 127 F.2d 458 (2d Cir. 1942); 3 Moore's Federal Practice, ¶15.15[6]. Thus, in the instant action, when this Court gave plaintiff the right to correct a defect in her complaint by repleading, the amended pleading would, of course, relate back to the date of the original pleading. The novel determination of Judge Gagliardi to the contrary is, we submit, clearly violative of Rule 15(c).

Defendants would analogize plaintiff's filing her amended pleading to a proposed intervention in a derivative action. The analogy and the cases relied on by defendants are wide of the mark.

In Pikor v. Cinerama Productions Corp., 25 F.R.D. 92 (S.D.N.Y. 1960), cited on page 13 of defendants' brief, various individuals moved to intervene as plaintiffs under Rule 24. The Court denied the motion for intervention because the motion was not accompanied by a pleading on behalf of the intervenors as required by Rule 24(c). The Court explained that this was not merely a technical lack of compliance with the rule. Rule 23 required that the complaint be verified by oath. It requires that the complaint shall specify that the plaintiff was a shareholder at the time of the transaction of which he complains and that the

action is not a collusive one to confer jurisdiction on the Court. The complaint should also set forth the efforts that plaintiff made to secure action from the company or the reasons for not making such effort. The Court held that if the proposed intervenors are to become plaintiffs in the action, there should be a verified complaint by them setting forth these allegations with respect to them. "They cannot expect that a complaint verified by somebody else establishes their capacity to sue under Rule 23." 25 F.R.D. at 96.

Similarly, in Abramson v. Pennwood Investment Corp., 392 F.2d 759 (2d Cir. 1968), the motion to intervene was denied because the proposed intervenor did not submit a complaint satisfying the requirements of Rule 24. Adopting the language of the Pikor decision, this Court stated: "Clearly, the sworn statement in appellant's motion papers that he was a stockholder at the time of the transaction is insufficient to meet the requirement of Rule 23(b)". 392 F.2d at 762. Defendants' reliance on the Mullins decision (motion to intervene not accompanied by a pleading) and the Bachrach decision (motion to intervene not accompanied by a pleading), both cited on page 13 of defendants' brief, is similarly misplaced. To compare plaintiff's status to that of a proposed intervenor on the basis of the above decisions is disingenious, since defendants disregard the reason for the decisions and the Rule (Rule 24) on which the decisions are based.

The other cases cited by defendants to support the decision below are also inappropriate. In Landy v. Federal Deposit Insurance Corporation, 486 F.2d 139 (3rd Cir. 1973), plaintiff had not made a demand for action on the receiver of the derivative corporation. On a motion to dismiss, the receiver stated to the Court that it intended to bring suit against all parties responsible for the collapse of the bank (the relief sought by the derivative shareholder). The district court dismissed the derivative claims because no demand had been made on the receiver and plaintiff had not shown why such demand would have been futile. On appeal, the Court of Appeals noted that subsequent to the district court's dismissal, the receiver had brought suit against many of the defendants named by plaintiff, but not all of them. Under those circumstances, the Court of Appeals decided to remand to the district court for consideration, the continuance of the derivative action as to the parties not sued by the receiver. This decision does not support Judge Gagliardi's refusal to relate back plaintiff's corrective amendment to the date of the original pleading.

In Lynam v. Livingston, 257 F. Supp. 520 (D. Del. 1966), cited at p. 13 of defendants' brief, plaintiff made demand (which was refused) after the action was

begun. She sought to "amend" (actually "supplement") her complaint to set forth these events. The Court granted her motion, stating that when a cause of action exists at the time when the original complaint is filed, but at that time a plaintiff lacks standing to enforce it, a Court has the power to permit the plaintiff to file a supplemental pleading to establish his right to sue, by reasons of facts occuring after the suit was begun.

Both the Landy and Lynam decisions were determinations favorable to a plaintiff, in line with the federal court's stated policy of seeking to have cases determined on their merits. These cases do not support Judge Gagliardi's final dismissal of this action. As this Court noted two years ago, this case involves serious charges of wrongdoing. It should be allowed to proceed to a determination on its merits.

POINT III

THE ALLEGED WRONGDOERS MAY NOT DICTATE WHETHER THE INJURED CORPORATION OR ITS STOCKHOLDERS IN A DERIVATIVE CAPACITY SHOULD BRING THIS SUIT.

Importantly, the Defendant Banks do not challenge the logic or reasonableness of plaintiff's proposition that in order to achieve the purpose for which Rule 23.1 was adopted, the preservation of the right of a corporation to control its own affairs, the use of the defense of failure to make a demand should be limited to the concerned corporation.

Defendant Banks, instead, assert that in Hawes v. Oakland, 104 U.S. 450 (1882), the failure to make demand was successfully raised by a defendant other than the derivative corporation. This is not correct. A careful reading of the case reveals that it was not a derivative action brought on behalf of the corporation, but a representative action brought by the plaintiff on behalf of himself "and all other stockholders who may choose to come in and contribute to the costs and expenses of the action" (104 U.S. at 450). Plaintiff asserted that the acts of which he complained had diminished the dividends which

should come to him and other stockholders, and had decreased the value of his stock. What the Supreme Court did was to sustain a demurrer by the City of Oakland that the plaintiff had "no capacity in himself to maintain this suit, the injury, if any exists, being to the interests of the corporation and the right to sue, belonging solely to that body" (104 U.S. at 451). This is quite similar to what this Court did when it dismissed the representative claims in this action. 482 F.2d 1111 (2d Cir.1973).

We have conceded that there have been many cases where the wrongdoers have been permitted to raise the defense of no demand on directors. We have stated, however, and reiterate that in not a single one of these cases has their right been challenged. We have cited the only case in which the question was the subject of a court statement, and in that case, the court specifically stated that the alleged wrongdoer should not be permitted to dictate whether the corporation or its shareholders in a derivative capacity should sue the wrongdoer. Ripley v. International Railways of Cent. America, 8 App. Div. 2d 310, 188 N.Y.S. 2d 62,72 (1st Dept. 1959), aff'd., 8 N.Y. 2d 430 (1960).

An examination of the New York case, Marco v. Sachs, 269 App. Div. 845, 55 N.Y.S.2d 406 (2d Dept.) aff'd.

295 N.Y. 642, 64 N.E.2d 711 (1945), decided fifteen years before the Ripley decision, and relied on heavily by Defendant Banks, reveals that the Court never discussed nor considered the issue raised herein. Nor was the issue presented to the Court in any of the cases cited on page 31 of Defendant Banks' brief.

We urge that the question of who has standing to raise the defense of no demand on directors warrants re-examination by this Court.

CONCLUSION

For the reasons stated herein and in our main brief, this Court should vacate the judgment of the District Court, deny Defendant Banks' motion to dismiss and allow this case to proceed to a determination on its merits.

May 5, 1975

Respectfully submitted,

WOLF POPPER ROSS WOLF & JONES
Attorneys for Plaintiff-Appellant
845 Third Avenue
New York, New York 10022

BENEDICT WOLF
LESTER L. LEVY

Of Counsel

AFFIDAVIT OF SERVICE BY MAIL

State of New York,
City of New York,
County of New York, ss.:

ALFRED BUSH, JR., being duly sworn, deposes and says that he is over 18 years of age. That on the 5th day of May, 1975, he served 2 copies of Plaintiff-Appellant's Reply Brief upon:

Wachtell, Lipton, Rosen & Katz
Attorneys for Defendant
Pennsylvania Company
230 Park Avenue
New York, New York 10017

Winthrop, Stimson, Putnam & Roberts
Attorneys for Defendant-Respondent,
Irving Trust Company
40 Wall Street
New York, New York 10005

Brady, Tarpey, Downey, Hoey, P.C.
Attorneys for Defendant-
Respondents, Bank of Montreal
84 William Street
New York, New York 10038

Milbank, Tweed, Hadley & McCloy
Attorneys for Defendants-Respondents
Chase Manhattan Bank, N.A. and
Girard Trust Bank
One Chase Manhattan Plaza
New York, New York 10005

Cravath, Swaine & Moore
Attorneys for Defendants-
Respondents Chemical Bank
and The Fidelity Bank
One Chase Manhattan Plaza
New York, New York 10005

Simpson, Thacher & Bartlett
Attorneys for Defendant-Respondent
Manufacturers Hanover Trust Company
One Battery Park Plaza
New York, New York 10004

By depositing 2 copies of the above-same securely enclosed in a post-paid wrapper in a branch depository maintained and exclusively controlled by the United States Post Office at Greenwich and Vestry Streets, addressed to said attorneys for the above-named, that being the address within the state designated by them for that purpose upon the preceding papers as the place where they regularly kept office and at which they regularly received mail.

Sworn to before me this
5th day of May, 1975.

Sylvia Morris

SYLVIA MORRIS
Notary Public for the State of New York
No. 31-4523651
Qualified in New York County
Commission Expires March 30, 1976

Alfred Bush Jr.